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# THE DEVELOPMENT OF COMMERCIAL MORTGAGE-BACKED SECURITIES IN AUSTRALIA

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## ABSTRACT

*The paper explores the development of the Australian Commercial Mortgage-Backed Securities (CMBS) market from 1999 to 2006 and outlines similarities and dissimilarities with the United States (US) and European (EU) CMBS markets. Whilst the US has been the market leader in terms of issuance volumes and diversity of asset classes backing the issues, the other two regions have not lagged far behind and have replicated the US CMBS model to suit their local needs. In comparison to the much bigger US and EU CMBS markets, the Australian CMBS market is well matured as seen by the diversity of asset classes backing the issues and transaction types, tightening spreads and record issuance volumes. The strong commercial real estate market outlook supports further CMBS issuance, with Listed Property Trusts (LPTs) continuing their dominance as issuers.*

**Keywords:** Commercial Mortgage-Backed Securities, underlying collateral, credit rating, transaction type, spreads, performance

## INTRODUCTION

In Australia, the description of Commercial Mortgage-Backed Securities (CMBS) has been expanded and accepted in the market to include a form of securitisation of direct property assets (Jones Lang LaSalle 2001), in addition to the traditional definition of the securitisation of commercial mortgages (Jacob and Fabozzi 2003). The Australian Commercial Mortgage-Backed Securities (CMBS) market has been one of the most dynamic and fastest-growing capital market sectors in the last few years (Richardson 2003). The market has undergone significant development since the first transactions came to the market in 1999, with a range of transaction types and issuers now accessing the market. The first CMBSs in Australia were done by Leda Holdings in 1999, the Longreach/Qantas head office securitisation and the David Jones flagship stores deals in 2000. To date, a total of over 60 CMBSs with nearly 180 tranches totalling over AU\$17.4 billion have been issued.

The growth of the CMBS market as a funding source and as an investment option is attributable to its advantages of lower pricing, improved liquidities, diversification on lenders, non-recourse to the parent company, release of value while retaining future

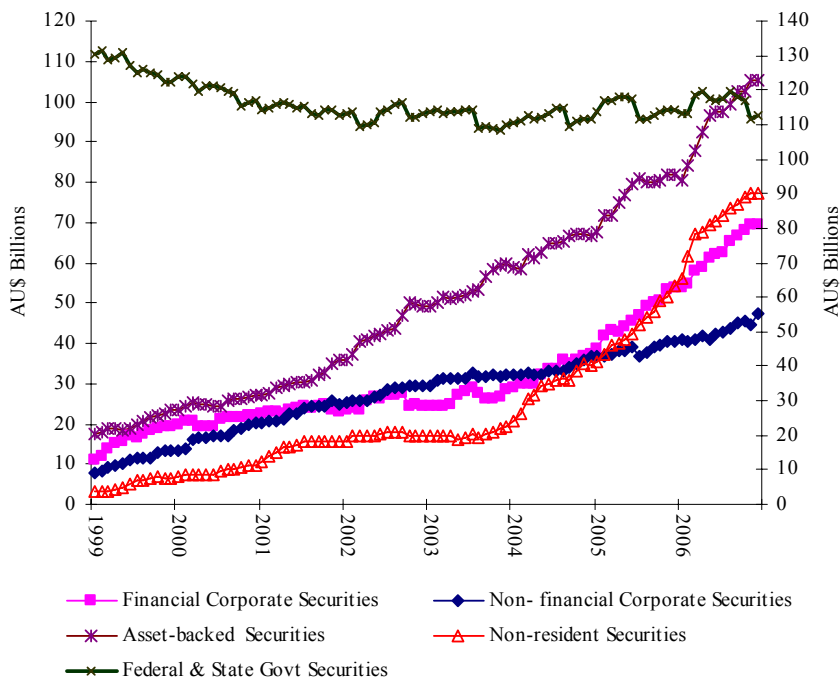
growth potential, and off-balance sheet financing in comparison to bank financing. Jones Lang LaSalle (2001) illustrated the potential of CMBSs being a cheaper and alternative debt financing option for companies with property exposure. They further added that CMBSs offered investor advantages of insolvency remoteness, greater diversification and greater transparency. Roche (2000), Blundell (2001) and Morrison (2001) also stated the advantages of CMBS over traditional bank financing as including cost effectiveness, flexible arrangement and longer repayment timeframes that closely match the long-term nature of property investment. The Reserve Bank of Australia (RBA) (2006) also noted that increased supply of CMBS, with a range of subordination, has broadened the investor base in real estate debt markets and reduced the commercial property sector's dependence on bank financing.

In Australia, the growth of the CMBS market is linked to that of Listed Property Trusts (LPTs). The single-purpose-vehicle-like characteristics of LPTs have helped in their establishment as major players in the CMBS market. LPTs continue to be the mainstay of the Australian CMBS market, with 65% of issuance market share. If wholesale funds are included, this figure increases to 75% (Standard & Poors 2005b). Draffin (2002) attributed the strong interest in CMBS issuance from LPTs to the ability to achieve AAA rating matched by strong investor demand; the cost effectiveness of CMBS debt relative to traditional forms of property finance; and the potential flexibility afforded by structured CMBS debt. Many LPTs used equity capital to fuel growth and expansion during the mid-1990's, but later switched to debt financing in 1997 when the RBA cut interest rates in the second half of 1996, which made debt financing a cheaper option to equity capital (Kavanagh 1997). Jones Jang LaSalle (2001) predicted the rise of LPT CMBSs on the premise that they had AU\$16 billion debt, of which 50% was bank debt. Between 2001 and 2004, LPTs issued CMBSs worth over AU\$3.7 billion via 27 issues (eg: Mirvac, Macquarie Goodman Industrial, ING Office, ING Industrial, Investa, Macquarie Office) and LPT bonds worth over \$AU4.8 billion via 40 issues (eg: Gandel, Commonwealth Property, GPT, Stockland, Westfield) (Newell and Tan 2005). This increased participation in CMBS issuance can also be partly attributed to the high demand by institutional investors, mainly superannuation funds, for shares and bonds issued by LPTs in comparison to investing in direct property.

The total contribution of asset allocation by Australian superannuation funds to property (both direct and indirect) declined from 17% in 1988 to 9% in 2000-2002, though the contribution of indirect property increased from 3% to 7% over the same period (InTech 2003). In 2005, 95% of superannuation funds had a specific allocation to property (either direct or indirect), averaging 10% (Newell 2006). The introduction of compulsory superannuation in 1992 saw superannuation funds increase their total assets from only AU\$36 billion in June 1984 and AU\$238 billion in June 2005 to AU\$946 billion in September 2006 (Australian Prudential Regulatory Authority 2006b). Their growth has been underpinned by strong investment returns and new contributions. With the drop in public bond issuance, bonds and CMBSs issued by LPTs have been an attractive investment option for superannuation funds. Outstanding government securities fell from

AU\$130 billion in 1999 to AU\$112 billion at the end of 2006. On the contrary, outstanding amounts for other debt securities; in particular asset backed securities<sup>1</sup> increased from AU\$17.5 billion to AU\$104 billion over the same period. Figure 1 shows outstanding debt securities from 1999 to 2006.

**Figure 1: Outstanding debt securities (1999-2006)**



Source: Reserve Bank of Australia (2007)

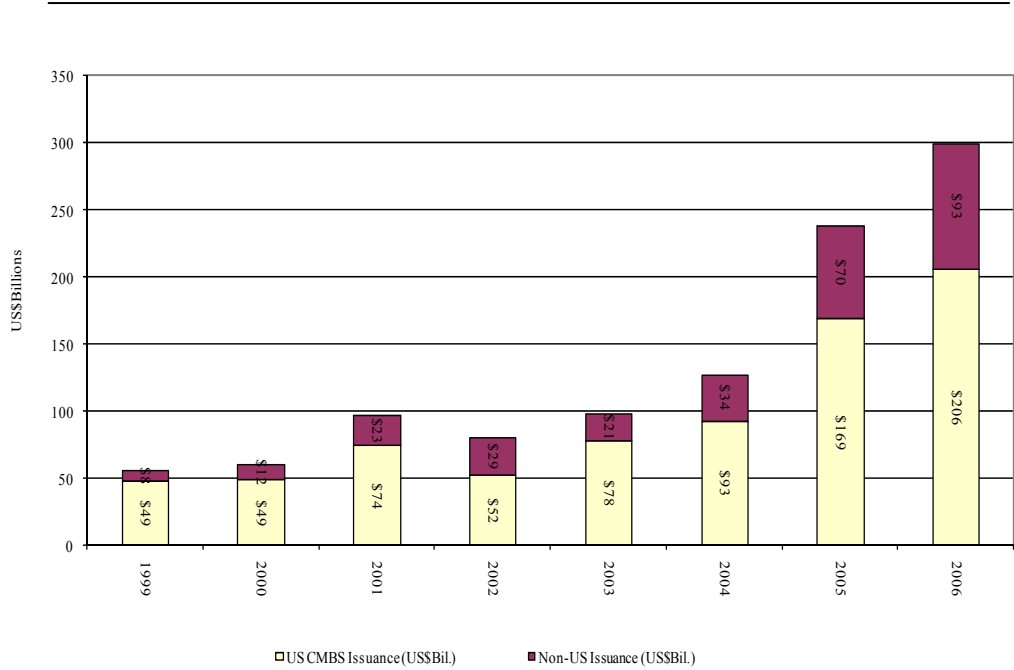
On a global level, the CMBS market increase is linked to the United States (US) market. For the 1999 to 2006 period, CMBSs totalling over AU \$977 billion (US\$770 billion)<sup>2</sup> had been issued in the US compared to AU\$367 billion (US\$289 billion) for the rest of the world; see Figure 2. Industry data shows that in 2006, issuance of commercial CMBS in the US was around AU\$261 billion (US\$206 billion), a 22% increase over the previous year, and non-US issues were AU\$118 billion (US\$93 billion), representing an increase of

<sup>1</sup> These include commercial mortgage-backed securities

<sup>2</sup> For ease of comparison, the interbank exchange rates of US\$1=AUS1.27 and EUR€1=AUS1.67 as at December 31, 2006 have been used.

34% over the 2005 period (Commercial Mortgage Alert 2007). There was strong activity in Europe (EU) in 2006, where around AU\$108 billion (€64.75 billion) of CMBS were issued in 2005, with around three quarters of this amount issued in the United Kingdom (UK). In 2006, AU\$4.9 billion of newly rated notes were issued in Australia, an increase of 38% on the previous year (Standard & Poors 2007b).

**Figure 2: CMBS global issuance (1999-2006)**



Source: Commercial Mortgage Alert (2007)

The 2006 CMBS issuance of AU\$261 billion (US\$206 billion) in the US, AU\$108 billion (€64.75 billion) in the EU and AU\$4.9 billion in Australia, represents 40%, 12% and 7% respectively of the overall securitisation markets in these regions (Standard & Poor's 2007a; 2007b). Although these percentages appear to be low except for the US, CMBSs are seen as a good source of funding by issuers and as a good investment option by investors.

As such, given the rapid growth of the Australian CMBS market, the purpose of this paper is to retrace this growth and compare it with that of US and the EU; particularly focussing on market structure and issues details. Furthermore, the paper presents a future outlook of the Australian CMBS market.

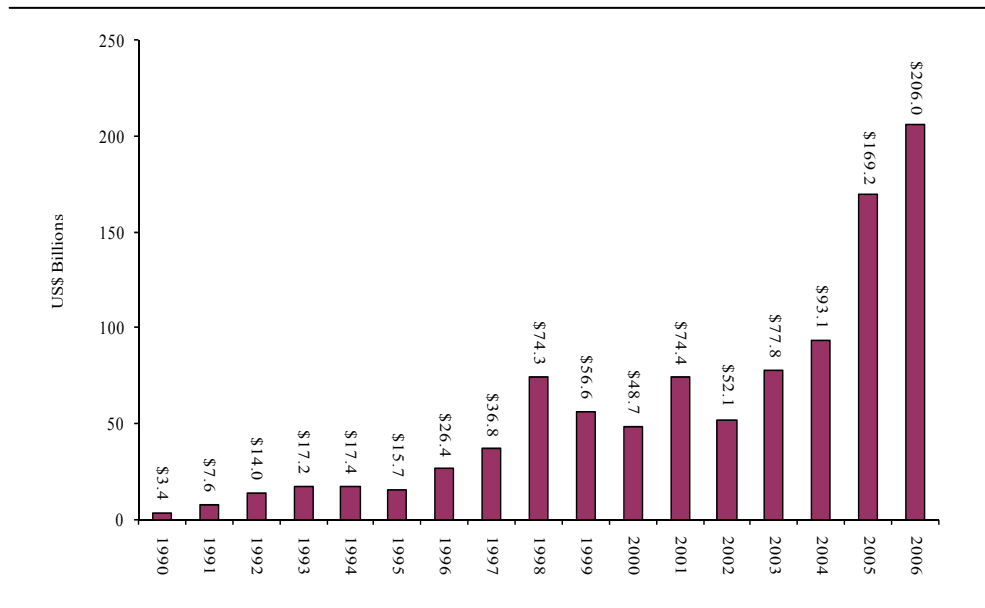
# SIGNIFICANCE OF COMMERCIAL MORTGAGE BACKED SECURITIES

The significance of the CMBS market is best illustrated by looking at developments in the bigger US and EU markets. Comparing with developments in the US and EU markets aids the analysis of how the Australian CMBS market has evolved.

## US CMBS market

The US has been leading the way in global issuance of CMBSSs. For the period 1990 to 2006, CMBSSs totalling over AU\$1257 billion (US\$990.7 billion) had been issued in the US. Figure 3 shows the total amount of CMBS issuance per year since 1990.

Figure 3: US CMBS issuance (1990-2006)

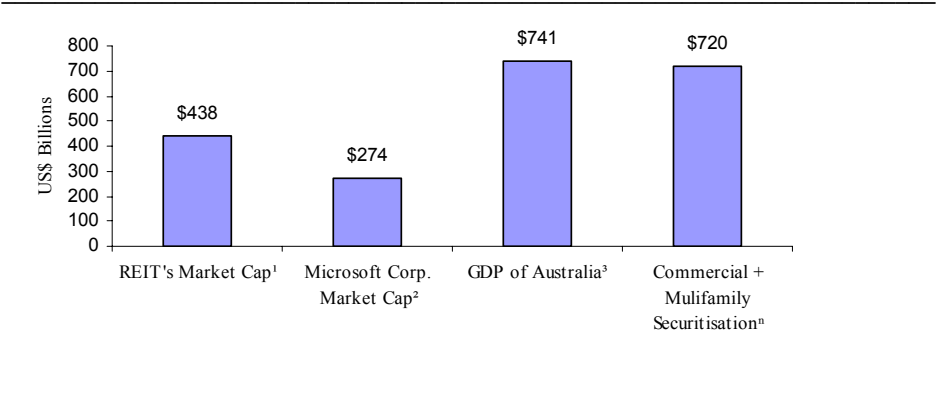


Source: Commercial Mortgage Alert

US CMBS issuance rose from AU\$4.3 billion (US\$3.4 billion) in 1990 to AU\$261 billion (US\$206 billion) in 2006. As of the second quarter of 2005, there was AU\$596 billion (\$470 billion) worth of CMBS outstanding in the US market, representing around 40% of the overall asset-backed securities market and around 20% of the overall commercial loan market.

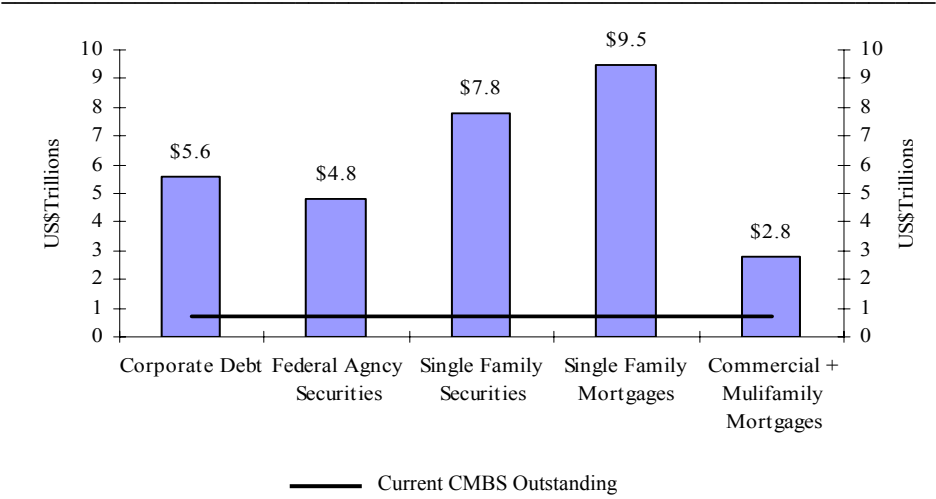
Figure 4 shows market size of commercial and multifamily securitisations (\$720 billion) with that of REITs (\$438 billion market cap), Microsoft (\$274 billion market cap on the New York Stock Exchange) and the GDP of Australia (\$720 billion). The \$720 billion worth of commercial and multifamily securitisations outstanding only represents about 26% of commercial and multifamily mortgages that have been issued (Figure 5). This further shows the growth potential of this investment class.

**Figure 4: Market comparison (as of December 31, 2006)**



Source: (1) NAREIT; (2) Microsoft Website(3) The Economist, January 3, 2007 (n)Federal Reserve, Flow of Funds

**Figure 5: Market comparison (as of September 30, 2006)**



Source: Federal Reserve, Flow of Funds

According to Commercial Mortgage Alert (2007), retail collateral has commanded roughly a 25% share of issues by value for several years. The multi-family sector has declined in its share as office properties have increased in importance. The industrial and hotel property types have retained relatively small, but significant shares.

Since 1993, the proportion of issues carrying triple-A ratings has increased steadily, largely as a result of a number of improvements throughout the CMBS market. Originators and issuers have improved underwriting, documentation and marketing, which have helped to improve the average loan quality. Rating agencies have improved the rating process, with more sophisticated models incorporating more historical performance data, thereby providing a better guidance on risk. Property market fundamentals have remained healthy; and the market for CMBS has deepened, particularly for highly rated securities such as triple A rated CMBS, encouraging an increase in their supply. This trend is also driven in part by the shallow market for lowest grade CMBS tranches<sup>3</sup>, a chronic condition that exerts significant influence on both the public and private real estate debt markets.

The last three years (2004-2006) have seen a predominance issuance of floating rate notes. In 2006, 81% of the issues were floating rate notes, representing an increase of 1.2 % and 4.9% over 2005 and 2004 respectively.

The US CMBS market is dominated by conduit/fusion transactions<sup>4</sup>. In 2006, they accounted for 88% of the outstanding CMBS issuance, and the large loan deals for the remaining 12% (Standard & Poors 2006b). For analytical purposes, re-REMICS, CRE CDOs and corporate-dependant deals have been included in the above two categories due to their special collateral characteristics.

Conduit transactions have had strong investor appeal as evidenced by contraction in spreads. Figure 7 shows the 10-year fixed conduit spreads between 1996 and 2006. The earlier years saw upward movements in annual average spreads of between 44 basis points (bp) and 53 bp, with the exception being 1998 which recorded a high of 111 bp. However, after 2001, there has been a fall from a high of 53 bp to just less than 30 bp as at the end of 2006 (Commercial Mortgage Alert 2007).

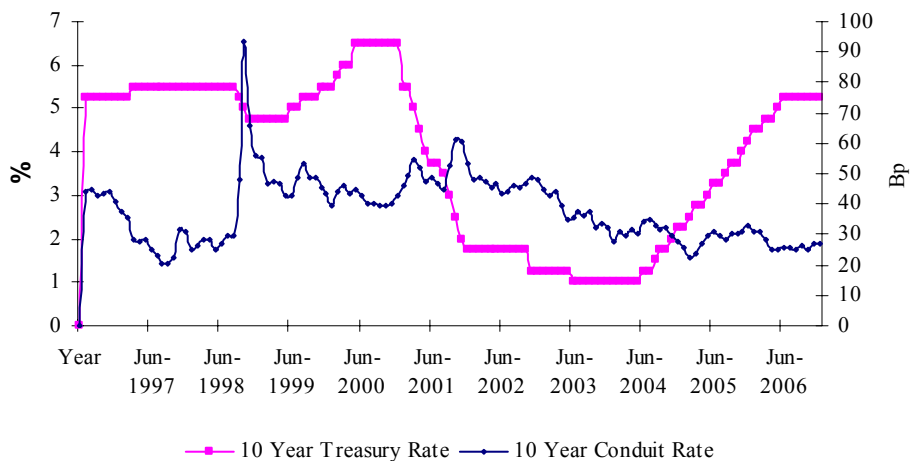
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<sup>3</sup> Tranching involves issuance of several classes of securities against a pool of assets, each with distinct risk-return profiles.

<sup>4</sup> CMBS backed by reasonably large, well diversified pools of small-to medium-sized and large-sized secured property loans.



**Figure 6: 10-year fixed conduit spreads and 10-year treasury rate**



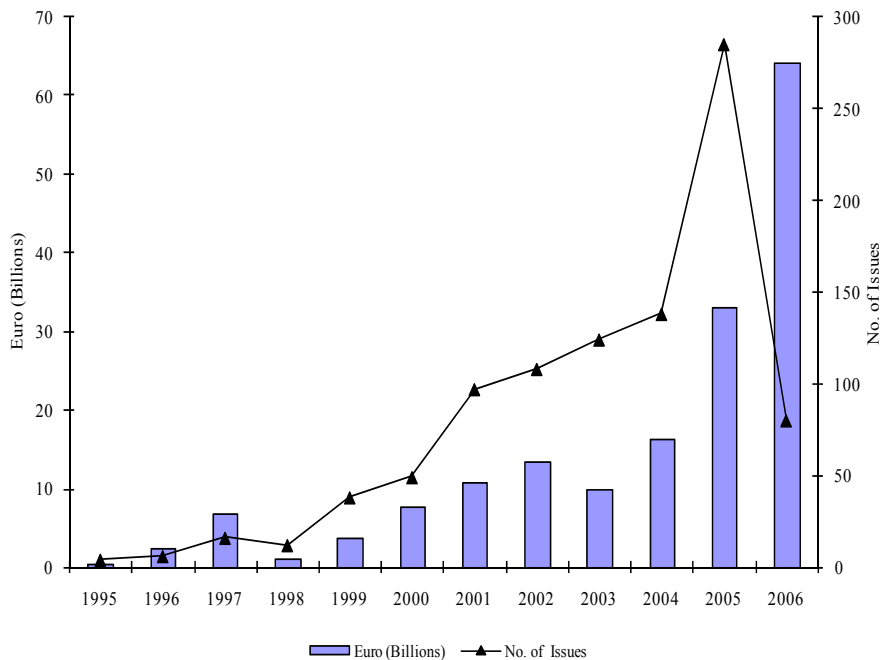
Source: Commercial Mortgage Alert

According to Fitch Ratings (2007b), by the end of 2006, the ratio of upgrades to downgrades was 34:1 (the highest ratio for structured finance products). Of the nearly 5000 CMBS deals they rated, the surveillance group upgraded 1,781 tranches and downgraded 52. Credit rating upgrades depict mainly an improvement in the performance of the underlying asset backing a CMBS issue and downgrades the opposite.

### EU CMBS market

EU CMBS issuance in 2006 was AU\$108 billion (€64.75 billion), an increase of 39% on 2005 levels. The number of transactions increased to 80 from 64 (Standard & Poors 2007a). Between 1997 and 2004, more than AU\$129 billion (€77 billion) was raised from 124 transactions. Figure 7 shows an historical overview of annual issuance.

**Figure 7: EU CMBS issuance: 1995-April 2006**



Source: Barclays Capital

The UK has been traditionally the dominant jurisdiction in EU CMBS issuance, accounting for 74% in 2004. Germany is rapidly catching up, with multifamily deals making up 23% of all CMBS and 29% of conduit deals in 2006 (Structured Finance International 2006).

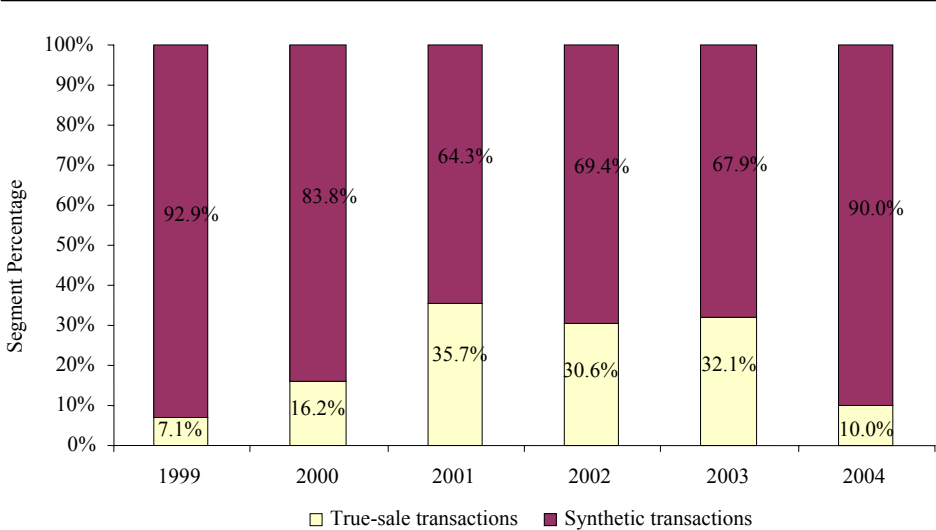
In terms of asset composition, office and retail properties continued to form the dominant collateral security in 2006 at 31% and 28% respectively. The residential sector emerged as a leading collateral security in 2006, mainly driven by securitisation of loans secured by German multifamily portfolios; it increased from 15% in 2005 to 23% in 2006 (Moody's Investor Service 2007a).

By 2005, EU CMBS issuance was largely in the AAA rating category, with 60% of the total and AU\$7.5 billion (€4.5 billion) worth of non-investment grade CMBS issued from 2000. Vresen (2005) points out that the majority of EU CMBS issuance from 2000 to Q1 2005 were floating notes averaging at 73%.

No single transaction type made up a majority issuance, mainly due to a wide range of legal structures to accommodate each of the transaction types. However, the single largest transaction type was the single-borrower single-property transaction with 28% of the total issuance to the end of 2004. Together, the single borrower and multi-borrower property categories made up 605 ( 68.8%) of the 879 issues as at end of 2005 (Vresen 2005).

EU CMBS transactions are generally grouped into three segments: true-sale single borrower<sup>5</sup>, true-sale multiple borrower<sup>6</sup> and synthetic transactions<sup>7</sup>. Figure 8 shows the dominance of true-sale transactions from 1999-2004. True-sale multiple borrower transactions comprised 68% and 42.3% of all true-sale transaction in 2003 and 2004 respectively (Moody's Investor Service 2005).

**Figure 8: EU CMBS volume by structure category (1999-2004)**



Source: Author’s compilation from various Moody’s Investor Service EU CMBS Year-end and Outlook Reports

Spreads tightened by approximately 60% in the last three quarters of 2004. In July 2004, the market saw AA spreads at around 40 bp, with two recent first quarter 2005 transactions closing at 17 bp for the AAA classes. This implied a 57.5% tightening in AAA over the last three quarters. Furthermore, the BBB class saw spreads at 200 bp in July and in the first quarter of 2005 at around 75%. This implied a 62.5% tightening at BB

<sup>5</sup> True-sale borrower (single property, multiple-property, liquidating pool, credit tenant lease)

<sup>6</sup> True-sale multiple borrower (single property and multiple property)

<sup>7</sup> Synthetic transactions are typically funded through the sale of credit linked notes

over the last three quarters. As a result, the difference between AAA and BBB spreads narrowed from 160 bp to only 58 bp, a 64% reduction (Vresen 2005). Obviously, lower spreads mean that bond investors are not being compensated as they were for similar risk. On the other hand, it also means that costs of funds for originators and borrowers are lower, making CMBS even more attractive as a financing source.

According to Vresen (2005), EU CMBS showed the best upgrade performance in 2004 of any major EU ABS sector, with 7.6% of the ratings being upgraded. This compares with an average upgrade in EU ABS of 4.5%. The 2004 CMBS downgrade-to-upgrade ratio was 0.4, just behind residential mortgage backed securities and consumer ABS, both which saw downgrades in 2004. Moody's (2007b) reported 2006 EU CMBS upgrades at 8% and downgrades at 2.1%.

## **METHODOLOGY AND DATA**

All CMBS presale reports from 1999 to 2006 as found in Standard and Poor's Ratings Direct database were assessed. During this period, a total of 65 issues with over 180 tranches, worth over AU\$14.8 billion were issued; this represents 100% of all the CMBS issued to 2006, excluding credit lease and small ticket transactions. These generic CMBSs which are single-borrower and multi-borrower transactions accounted for 62% of all the CMBS issuances in 2005 (Standard & Poor's 2005a). Credit lease and small ticket transactions are not discussed in this paper. Tables 1 and 2 show some of the major CMBS issues and some of the major properties in the portfolios backing these issues respectively.

Specific details obtained per CMBS issue were on issue size, underlying collateral, rating tranche distributions, interest rate types and transaction types. Details on CMBS market size, spread trends, and performance of the issues were obtained from other secondary sources. All these were used to assess how the market had developed and to compare and contrast with that of the US and EU. A cogent review and explanation of these features will help to understand the changing nature of the Australian CMBS market. Using the historical approach, a researcher endeavours to record and understand events of the past. In turn, interpretations of recorded history hold to provide better understanding of the present and suggest possible future directions (Baumgartner and Hensley 2005).

**Table 1: Major Australian CMBS issues by transaction type**

No.	Issue Date	Sector	Issue	Transaction Type	S&P Rating	Issued Amount (AU\$m)	Coupon Type	Coupon/ BBSW+	Scheduled Maturity	DSCR**	LTV**	Security
1	Apr-01	Office	CPIT 2006 Aurora Bonds	Single-borrower single-property	Aaa*	150	Floating	41	Mar-06	2.0	32%	ABN AMRO Office Tower with a total portfolio value of AU\$713 million
2	Jun-01	Diversified	Mirvac Capital Pty Ltd - Series 2001-1	Single-borrower multi-property	AAA AAA	150 350	Fixed Floating	6.50% 41	Jun-06 Jun-06	2.2 2.2	40% 40%	25 modern, investment-grade buildings in the office, hotel, retail, industrial & carpark sectors with a total portfolio value of AU\$1,430 million
3	Feb-02	Office	ING Office Finance Pty Ltd	Single-borrower multi-property	AAA AAA	230 178	Fixed Floating	6.25% 40	Feb-07 Feb-07	2.4 2.4	39% 39%	18 commercial office properties with a total portfolio value of AU\$1,215 million
4	Jun-02	Diversified	Challenger Capital Markets Ltd	Multi-borrower multi-property	AAA AAA A A BBB+ BBB BBB NR	100 120 61 54 55 17 10 99	Fixed Floating Fixed Floating Floating Fixed Floating Floating	6.00% 40 6.50% 80 100 6.75% 130 P	Jun-05 Jun-05 Jul-05 Jul-05 Jul-05 Jul-05 Jul-05 Jul-05	2.7 2.7 1.8 1.8 1.5 1.4 1.4 2.7	32% 32% 48% 48% 56% 60% 60% 32%	25 retail, office, industrial, cinema and car park properties with a total portfolio value of AU\$798 million
5	Nov-03	Retail	ALE Finance Company Pty Ltd - Series 1	Whole-business	AAA AAA AAA AAA AA	100 110 45 35 40	Fixed Floating Floating Floating Floating	6.60% 47 90 120 67	Nov-08 Nov-08 Nov-08 Nov-08 Nov-08	3.1 3.1 2.2 1.8 2.6	43% 43% 60% 71% 51%	101 pub assets with a total portfolio value of AU\$562 million
6	May-05	Office	Multiplex MPT CMBS Series 2005-1	Single-borrower multi-property	AAA AA A BBB BBB-	343 61 54 51 28	Floating Floating Floating Floating Floating	20 30 40 57 80	May-08 May-08 May-08 May-08 May-08	2.0 1.7 1.5 1.4 1.3	40% 47% 53% 59% 62%	8 commercial properties with a total portfolio value of AU\$932 million
7	May-05	Diversified	Multiplex MPT CMBS Series 2005-2	Single-borrower multi-property	AAA AA A BBB BBB-	298 53 39 52 21	Floating Floating Floating Floating Floating	25 40 50 75 90	May-10 May-10 May-10 May-10 May-10	2.0 1.7 1.5 1.4 1.3	40% 47% 52% 59% 62%	5 commercial and 4 retail properties with a total portfolio value of AU\$804 million

8	Dec-06	Office	Series MCWF 2006-1	Single- borrower multi- property	AAA AA A BBB BBB-	320 50 25 30 15	Floating Floating Floating Floating Floating	19 23 27 47 57	Jun-11 Jun-11 Jun-11 Jun-11 Jun-11	1.8 1.5 1.5 1.4 1.3	44% 51% 54% 58% 60%	52 retail centres with a total portfolio value of AU\$802 million
9	Dec-06	Office	WOT CMBS Pty Ltd Series 1	Single- borrower multi- property	AAA AA A BBB	320 45 90 50	Floating Floating Floating Floating	26 31 41 61	May-11 May-11 May-11 May-11	N/K N/K N/K N/K	N/K N/K N/K N/K	2 office buildings, 1 retail building and 1 university building with a total portfolio value of AUS
10	Dec-06	Retail	Centro Shopping Centre Securities - CMBS Series 2006- 1	Conduit	AAA AAA AAA AA A BBB BBB-	250 300 170 37 62 53 28	Floating Floating Floating Floating Floating Floating Floating	19 24 18 28 40 65 85	N/K N/K N/K N/K N/K N/K N/K	1.8 1.8 1.8 1.8 1.8 1.8 1.8	43% 43% 43% 45% 49% 52% 54%	13 mortgage facilities secured against 47 retail properties and 1 retail distribution centre with a total portfolio value of AU\$1,580 million

N/K: Not Known

Source: Author's compilation from various Standard and Poor's CMBS presale reports

**Table 2: Major properties in Australian CMBS issues**

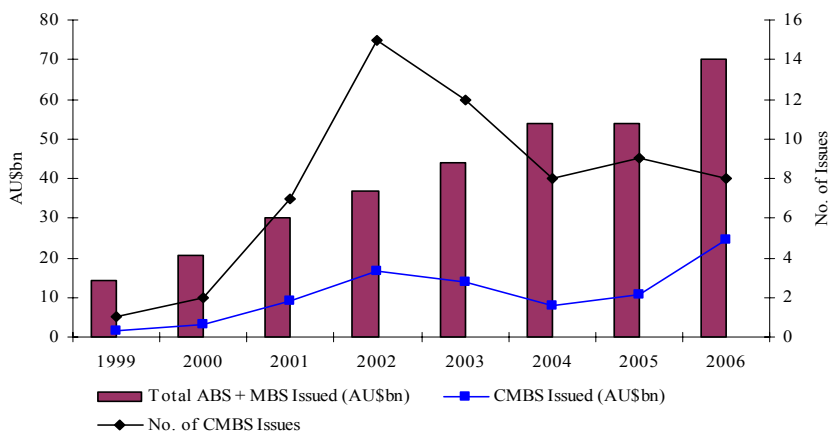
<b>Sector</b>	<b>Issue</b>	<b>Date of Issue</b>	<b>Major Property in Issue</b>	<b>Property Value (AUS M)</b>
Office	CPIT 2006 Aurora Bonds	Apr-01	ABN AMRO Tower	\$495
Office	Deutsche Office Finance 2004-CMBS Trust	May-04	Governor Phillip Tower and Governor Macquarie Tower, Sydney NSW	\$478
Retail/Office/Hotel	Quay 62 Pty Ltd Series 2005-1	Apr-05	Collins Place, 25-55 Collins Street, Melbourne VIC	\$425
Retail	Quay 62 Pty Ltd Series 2003-1	Oct-03	Southland, VIC	\$350
Office	Mirvac Capital Pty Ltd	Jun-01	The Optus Centre, Miller St NSW	\$330
Retail	Deutsche Office Finance 2004-CMBS Trust	May-04	Southgate Complex, Melbourne VIC	\$316
Retail	Centro Shopping Centre Securities Limited - CMBS Series 2006-1	Jun-06	Centro Galleria, WA (50%) & Centro Goulburn, NSW (50%)	\$299
Retail	Quay 62 Pty Ltd Series 2003-1	Oct-03	Pacific Fair, Broadbeach	\$292
Industrial	Deutsche Industrial Finance 2002 - CMBS Trust	Dec-02	DB Office Park, North Ryde NSW	\$103
Industrial	Macquarie Goodman Industrial Finance Pty Ltd.	Nov-01	City West Office Park, Pyrmont NSW	\$93

Source: Author's compilation from various Standard and Poor's CMBS presale reports

# ANALYSIS OF AUSTRALIAN COMMERCIAL MORTGAGE BACKED SECURITIES

The overall cumulative Australian CMBS issuance since 1999 reached AU\$17.5 billion at the end of 2006. In 2006, a record number of new issuances exceeding AU\$4.9 billion were issued, passing the earlier issuance record year of 2002 (AU\$3.7 billion)(Standard & Poors 2007b). The years 2003 and 2005 produced stable issuances of over AU\$2 billion per year. In 2004, there was a slight fall in issuances to AU\$1.6 billion. Figure 9 shows the volume of CMBS issuances since 1999 in dollar amount and number of issues per annum. It also shows the size of the CMBS issues in relation to the overall asset backed securities market. The total ABS issuance in the year 2006 was AU\$70 billion, of which the CMBS sub-market accounted for 7%. This represents a significant leap from 2% of the \$14.4 billion ABS total issuance in 1999 (Fitch Ratings 2007a).

**Figure 9: Australian annual ABS/MBS/CMBS issuance volumes**



Source: Standard and Poors (2006a)

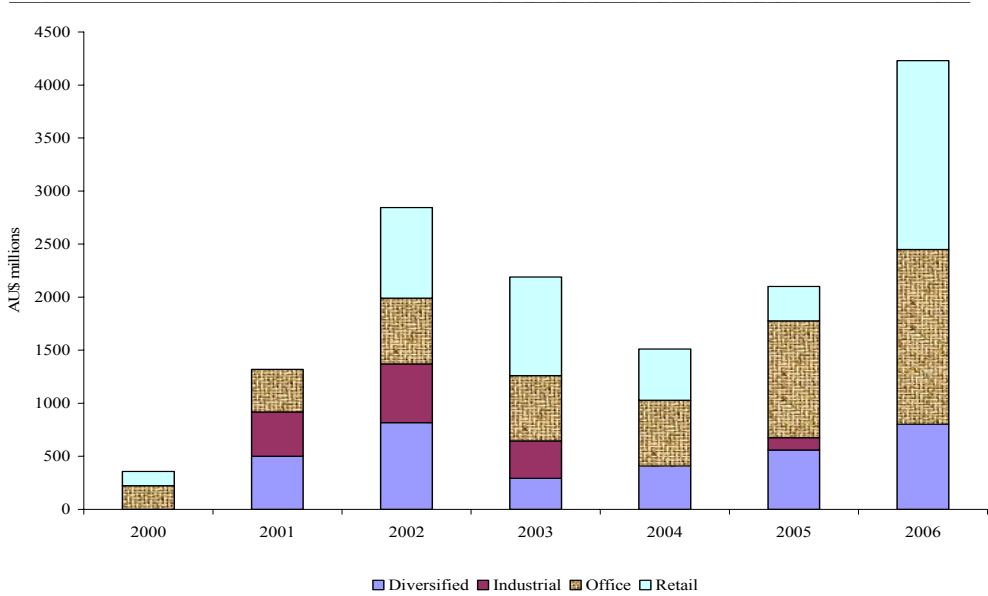
The last three years has seen an average number of issues of eight which is lower than the record number of issuances of fourteen in 2002. However, the size of issues has been increasing. For instance, all the new issues in 2006 each had a combined tranche value of over AU\$400 million. Furthermore, the last two years have seen record issue sizes with AU\$1 billion for Multiplex MPT CMBS Series 2005-1&2 in 2005 and AU\$900 million for Centro Shopping Centre Securities - CMBS Series 2006-1 in 2006.

Figure 10 presents CMBS issuance by sector from 2000 to 2006, excluding credit lease and small ticket transactions. Over this six year period, the most dominant CMBS issues



have been in the office sector (AU\$5.2 billion), followed by the retail sector (AU\$4.5 billion). The diversified sector and the industrial sector have had AU\$3.4 billion and AU\$1.4 billion worth of CMBS issuance respectively.

**Figure 10: Australian CMBS issuance by sector (2000-2006)**



Source: Author’s compilation from Standard and Poor’s presale reports

Over 2000-2006, diversified backed issues had the most tranches at 31%, followed by retail backed issues at 28% and office at 23%. The least number of tranches were in the industrial backed issues at 18%. This is shown in Table 3.

**Table 3: Number of tranches in Australian CMBS issues (2000-2006)**

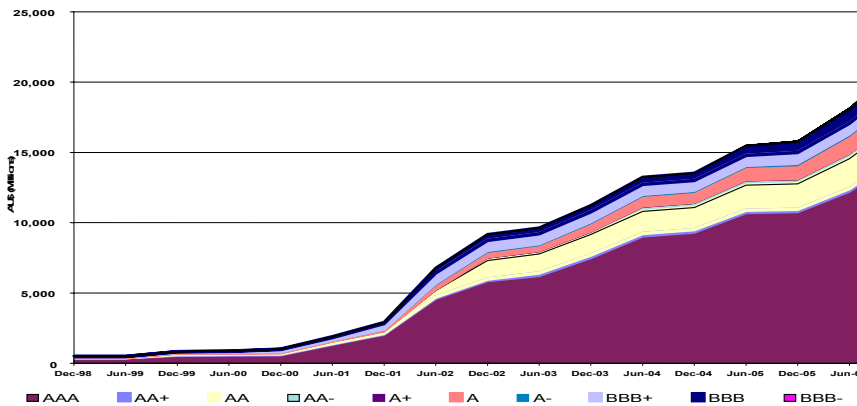
Sector	2000	2001	2002	2003	2004	2005	2006	2000-2006	% of Total
Diversified	1	2	11	7	7	14	13	55	31%
Industrial	4	3	6	12	4	3	0	32	18%
Office	0	3	4	5	9	10	11	42	23%
Retail	0	0	15	9	0	8	18	50	28%
Total	5	8	36	33	20	35	42	179	100%

Source: Author’s compilation from Standard and Poor’s presale reports

Majority of the tranches have been A-class rated, though lower B-class tranches are becoming common as well (Figure 11). This shows the growth/maturing of the market,

increased acceptance of the investment asset and the increased participation of more knowledgeable investors.

**Figure 11: Australian CMBS issuance by tranche type and amount (1998-2006)**



Source: Standard and Poors, 2006 #362

A combination of both fixed-interest and floating-rate notes have been issued to attract a broad spectrum of investors. In the earlier years, floating rate notes and fixed rate notes were issued in equal proportions. However, the last few years have been predominated by floating rate notes. For instance, in 2005, 68% were floating rate notes in comparison to 32% fixed rate notes.

Majority of the issues are in the single borrower multi-property category, with over 95% of the total issuance to date. The CPIT 2006 Aurora Bonds CMBS issued in April 2001 is the only single borrower single-property issuance to date being for a single Sydney CBD office property. Two multi-borrower multi-property issues have been by MCS Capital Pty Limited issued in May 2002 and Challenger Capital Markets Ltd issued in June 2002. ALE Finance Company Pty Ltd - Series 1 CMBS, issued first in November 2003 and its tap issue in April 2006, is the only whole-business CMBS to date.

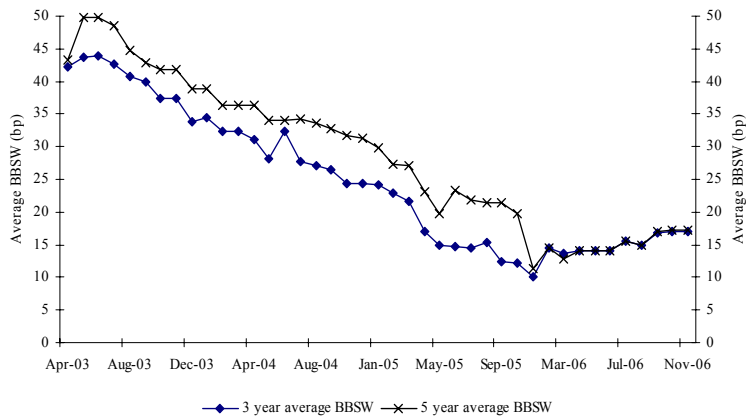
2006 saw the introduction of the first Australian conduit-style CMBS common in the US, Centro Shopping Centre Securities Ltd, CMBS Series 2006-1. This AU\$900 million transaction is the securitisation of a portfolio of 13 non cross-collateralised and non cross-defaulted real estate backed debt facilities to 12 obligators. Each financing is backed by between 1 and 11 retail properties located in major Australian cities and regional centres.

The total independent value of the asset-backing of the issue was AU\$1.67 billion. The diversity of issuance transaction types show the maturity of the market, as well as the arranger’s confidence in trying out various CMBS structures to suit market needs.

These deals are structured on a ‘secured loan’<sup>8</sup> basis, unlike other parts of the world where they are done on a ‘true-sale’ basis. A possible explanation is the predominance of Listed Property Trusts in the CMBS market, having a 65% market share (Standard & Poors 2005b). LPTs’ core business is real estate investment and retaining control of the securitised assets is critical to their survival.

Given the general appetite for fixed-income securities and the limited supply in the market, CMBS credit spreads were contracting until the end of 2005 and have been stable since the start of 2006 as shown in Figure 12. In 2005, ‘AAA’ five-year, interest only notes were priced at 20-25 bps (basis points) over three month bank bill swap (BBSW), and three-year, interest-only notes at 17-20 bps over three-month BBSW. ‘BBB’ were priced at 60-95 bps over BBSW. These margins were lower than those of 2002, when they were priced at least 20 bps wider for ‘AAA’ and 60 bps wider at ‘BBB’ level. At the beginning of 2006, both ‘AAA’ five-year and ‘AAA’ three-year were trading at average ranges of 8-10 bps; as at the end of 2006, they were trading at average ranges of 15-17 bps.

**Figure 12: AAA rated CMBS - average industrial spread to swap (April 2003- November 2006)**



Source: Author’s compilation from Property Australia magazine

<sup>8</sup> This involves “selling” assets to a special-purpose “bankruptcy-remote” entity that, in turn, pledges the assets as collateral for a loan and then conveys the borrowed funds to the “seller” as consideration.

Over the past three years (2003-2006), there were more upgrades than downgrades, buoyed by improvements in property performance. Stable property markets continue to be reflected in steady cash flows and occupancy trends. No rating changes were experienced throughout the second half of 2005. Of the six rating changes in 2006, three upgrades resulted from improved property performance and the three downgrades resulted from lowering of a support party rating. 2006 also had fifteen rating affirmations (Standard & Poors 2007b). Table 4 shows the total number of upgrades and downgrades between 2003 and 2006.

**Table 4: Australian CMBS upgrades and downgrades**

<b>Year</b>	<b>Upgrades</b>	<b>Downgrades</b>	<b>No. of Ratings</b>
<b>2003</b>	1	1	135
<b>2004</b>	4	0	136
<b>2005</b>	0	1	134
<b>2006</b>	3	0	136
<b>Total</b>	8	2	541

Source: Standard and Poors (2006)

## FUTURE OUTLOOK OF AUSTRALIAN CMBS

The following support continued dominance of LPTs in CMBS issuance:

- Their structure and single-purpose nature have been well established and accepted in the market. Only about a third of the 48 LPTs have issued CMBSs. The others are yet to utilise them as funding sources.
- Of the AU\$116 billion (68% market coverage) institutionally owned property in Australia, LPTs contribute AU\$75 billion (61% of total) (Higgins 2006). These assets are best suited for securitisation due to their high capital values and stable cash flows.
- The low gearing levels in comparison to the US (Newell and Tan 2005) present possibility for further issuance of debt securities via CMBS. Australian LPTs had an average gearing level of 42.1%, whereas their US counter-parts (Real Estate Investment Trusts) had levels higher than 50% (BDO Chartered Accountants & Advisers 2006).
- The provision to buy and sale collateral assets in CMBS portfolios supports market growth though ‘tap’ issuances. In 2006, over 80% of activity came from tap issues, refinancing and restructurings from existing sponsors (Efrat 2006).

- The insatiable demand alluded to earlier by superannuation funds for fixed income securities issued by LPTs.

Many industry experts are divided on the role that unlisted property trusts will play in the growth of the CMBS market (Efrat 2006). Some contend that unlisted property trusts have become sophisticated and have outgrown their existing financing mechanisms and that CMBS are an alternative debt funding tool for them. However, others have highlighted that the higher unlisted property trust gearing levels would entail issuance of lower rated tranches, for example, double B and lower, which are not favourable for both issuers and investors.

The launch of Centro Shopping Centre Securities - CMBS Series 2006-1 in 2006 marked a milestone in the Australian CMBS market. Being the first such multi-borrower program, it is anticipated that momentum for other similar issues will come from small to medium enterprises and the loans this sector has sitting on bank's books, most of which hasn't historically been securitised. As at June 2006, total commercial property exposure by all banks was AU\$94.5 billion, with 0.4% and 0.2% classified as nonperforming and impaired<sup>9</sup> respectively (Reserve Bank of Australia 2006). Banks have generally been reluctant to securitise their commercial property loans due to the low default rates as shown in Table 5.

**Table 5: Australian commercial bank property exposure**

<b>Sector</b>	<b>Commercial Property Exposure- All Banks (%)</b>	<b>Share of Total Commercial Lending (%)</b>	<b>Impaired Assets Share of Commercial Property Exposure (%)</b>
Office	25.5	10	0.1
Retail	18.5	7	0.1
Industrial	10.7	4	0
Land Developments/subdivisions	10.8	*	*
Residential	17.8	11	0.4
Tourism and leisure	4.4	2	0.1
Other	12.3	4	0.2
<b>Total</b>	<b>100</b>	<b>37</b>	<b>0.2</b>

Source: Reserve Bank of Australia (2006); Australian Prudential Regulatory Authority (2006)

<sup>9</sup> Assets on which payments are in arrears by more than 90 days or otherwise doubtful and the amount due is not well covered by the value of collateral. The remainder of these assets were in arrears, but were well covered by collateral.

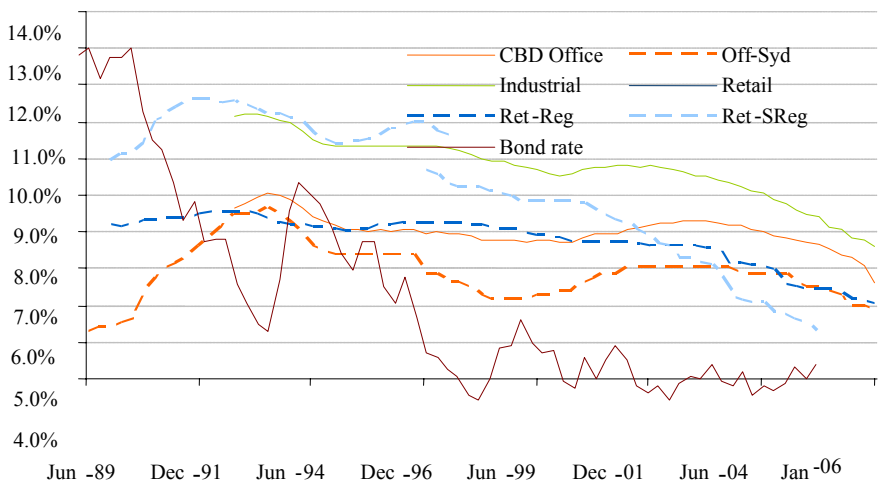
The strong commercial real estate market outlook supports further CMBS issuance. Investors in real estate have been rewarded with strong returns with both direct property and LPTs outperforming shares and bonds over a ten-year period to Q4.2005; see Table 6 (PCA/IPD 2007; UBS 2007). This has reinforced the importance of real estate as an asset class in its own right, leading to sustained demand for real estate as evidenced by continued yield compression. Figure 13 shows yield trends in the retail, office and industrial sectors from 1991 to 2006. These trends are expected to continue due to the limited number of 'investment-grade' properties (Murdoch 2004) and the huge amounts being allocated to property investment, as alluded to earlier. The future outlook of various property sectors is positive: there is strong economic outlook and investor sentiment for industrial property (Jones Lang LaSalle 2006c; Newell and Peng 2007); continued catalysts to growth in retail property of strong rental growth, stable income streams, favourable planning environment limiting new supply and undue competition, and strong investor support (Burdekin and Snoswell 2004); and further office market growth underpinned by strong economic growth. Australia is ranked as the sixth most competitive country in the world (IMD 2006) and Sydney ranks highly at 46 in CB Richard Ellis' Global Market Rents Report at November 2006 (CB Richard Ellis 2006). Sydney and Melbourne also feature prominently among major Asia-Pacific cities at sixth and tenth respectively in Jones Lang LaSalle's Asia Pacific Property Digest (Jones Lang LaSalle 2006a). Generally, office markets across Australia have performed well, with record sales activity and rental growth in Perth and Brisbane.

**Table 6: Asset class performance Q4:2006**

Asset Class	Average Annual Return (%)			
	1Y	3Y	5Y	10Y
Direct property	17.29%	14.48%	12.96%	11.68%
Office	17.76%	12.21%	10.24%	10.14%
Retail	17.67%	16.40%	15.40%	12.84%
Industrial	13.43%	12.91%	13.27%	13.59%
LPTs	25.90%	19.40%	16.10%	16.07%
Office	19.60%	13.00%	11.80%	10.80%
Retail	28.10%	20.50%	18.10%	16.40%
Industrial	36.20%	27.20%	20.40%	17.80%
Shares	20.50%	15.50%	13.10%	13.11%
Bonds	5.30%	5.50%	6.50%	6.33%

Source: PIR (2007); UBS (2007)

**Figure 13: Australian commercial property yields (1989-2006)**



# CONCLUSION

Understanding global CMBS trends is important for investors and issuers. The globalisation of financial markets has seen the developments in the US CMBS market replicated in other parts of the world, albeit with some adaptation to suit local conditions. Conduit programs in the EU are predominantly single borrower transactions and have just been introduced in Australia. Single borrower transactions are the dominant issuance vehicles in both the EU and Australia. In the US, multi-borrower conduit transactions dominate.

The last few years have seen spreads tighten in US, EU and Australia, showing the appeal of CMBS as a funding source. The performance of CMBSs has also been good as characterised by the number of CMBS credit rating upgrades outstripping downgrades. This is attributable to the strong property performance supported by improving business climate and the persistently low interest rate environment which has spurred demand for alternative investments, such as real estate, as part of the broadening hunt for higher yielding, and commensurately riskier assets (ECB 2007: 58 ).

The Australian CMBS market is well matured as can be seen by comparison with the much bigger US and EU CMBS markets. High property market transparency (Jones Lang LaSalle 2006b) and predominance of LPTs as CMBS issuers (Standard & Poors 2005b), who legally have to report their activities and underlying collateral performance to regulatory regimes such as ASX/ASIC and their equity partners, have contributed to the success of the Australian CMBS market.

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